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STATE, LIBERALIZATION, AND INVESTMENT QUESTION:

ISSUES IN CORPORATE GOVERNANCE

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ABSTRACT

Foreign direct investment (FDI) occurs when a firm undertakes an investment in an overseas enterprise, in which the foreign investor has both the lasting interest and substantial control. FDI implies that the investor exerts a considerable degree of influence on the management of the overseas enterprise. FDI can be wholly owned (either acquisitions or green field) or joint ventures. With FDI, the investing firm assumes greater risks, compared with licensing or exporting, but has considerably more management control over the overseas operation.

For the host country it is a source of additional external finance (and of risk capital) augmenting fixed investment, potential output and employment. FDI is also seen as a source of technology and management skill, creating tangible and intangible assets in the host country. However, empirical researches throw mixed results. Many researchers find that in practice FDI does not create the benefits that are expected to flow to the host country.

Corporate governance literature focuses on the agency problem and addresses issues that arise due to the separation of ownership and control. It primarily deals with the role of various groups of investors (e.g., large shareholders, bond holders, and institutional investors) in ensuring that:

- a) The management focuses on the maximization of the firm value.
- b) The shareholder-group that controls the management of assets is not expropriating wealth that belongs to investors.
- c) The shareholder group that is in control does not entrench the management in spite of poor performance.

Some believe in the stakeholder theory. It says that a firm should be managed to benefit all stakeholders.

Corporate governance in the context of FDI should be viewed from two different perspectives. It may be examined from the point of view of the relationship between the foreign investor and the partner firm from the host country in a joint venture. It may also be examined from the perspective of the relationship between the foreign investor, the partner from the host country, and the government of the host country.

Corporate governance in an international joint venture (IJV) needs to focus on certain complex issues, which can be summarized as follows:

- a) Control by the foreign partner without majority voting power because the State puts restrictions on the share holding of the foreign partner or on the voting power of the foreign partner.
- b) Separation of strategic control and operating control.
- c) Focus on maximization of value for the shareholders of the foreign partner rather than maximization of the value of the IJV.

The relative bargaining power of the foreign partner is the most important variable that determines the relationship between the foreign partner and the partner from the host country.

Corporate governance from the perspective of the relationship between the foreign investor, the partner from the host country, and the government of the host country should be viewed as the governance of contracts. FDI results in a tripartite contract among the State, the foreign partner and the partner from the host country. The government policy and regulation are the instruments that set the contractual terms and conditions from the perspective of the State. The governance issue arises when the terms settled ex-ante is not adequate to take care of contingencies occurring after the initial contract and the question of sharing the quasi rent arises. The sharing depends on the relative bargaining power of the contracting agents. The government changes policy and regulations in favor of foreign investors if they as a group enjoy strong bargaining power. This reduces the pay off to the host country from the FDI. Therefore, the governance from the point of view of the State requires managing the bargaining power of the foreign investor. The State endeavors to do the same by restricting FDI only in those areas where the potential for technical and other spill over is high and by creating indigenous capabilities to avoid total dependence on foreign investment in a particular area.

This paper examines these issues in a broader perspective in the context of recent government initiatives to attract FDI.

1. INTRODUCTION

The vast bulk of economic activity occurs within formal, managed organizations rather than through market exchanges. McMillan (2002) estimates that less than one-third of all transactions in the U. S. economy occur through markets and over 70 per cent of transactions occur within firms. Firms occupy a predominant position in any economy, primarily because in many situations market fails to achieve the desired coordination of activities and motivation of people to carry on the needed activities to achieve economic efficiency¹. Activities are taken within the boundaries of a firm to achieve better coordination and motivation and also to reduce transaction costs. In many situations, the productivity of resources increases as a firm grows and achieves economies of scale² and

economies of scope³, although the optimal size differs between firms and between industries. This results in the emergence of large corporations. Among the firm structures, 'limited liability company' form is considered as the most appropriate structure to carry out large and complex businesses. In a limited liability company management of assets rests with promoter managers or professional managers and not with investors. Therefore, 'State' takes various initiatives to protect investors' wealth from expropriation and to motivate investors to invest in large firms.

A business firm creates value by trading in goods and services or by producing and selling goods and services. The value so created is distributed among stakeholders of the firm, some of whom are internal to the firm (employees and investors) and participate in the process of creating value, while others are external to the firm and trade with the firm such as buyers of firm products and sellers of inputs to the firm. The community that does not trade with the firm is also external to the firm.

Corporate governance deals with governance of business firms, particularly limited liability companies. Corporate governance refers to mechanisms that aim is to achieve economic efficiency and fair distribution of surplus (revenue less bought out inputs) to those who are internal to the firm and provide resources (e.g. financial capital, knowledge and skills, and labour) to the firm. . Distribution of value (created by a firm) to those who trade with the firm is determined by price in market exchanges. The share of the community (which is external to the firm) in the value created by the firm is determined by the 'State', which levies taxes (e.g. income tax) and formulates laws to protect the interest of the community.

There are two approaches to address the problems in corporate governance. One is popularly known as the shareholder theory of corporate governance and the other is known as the stakeholder theory of corporate governance. The shareholder theory of corporate governance is based on the assumption that the core objective function of a firm is 'maximisation of firm value'. Therefore, managers are expected to take decisions to 'maximise the firm value'. Firm value is the total of the market value of equity and the market value of debt. The corporate governance system aims to protect interests of financiers by ensuring that managers take decisions to achieve the core objective function of the firm and that the value created (surplus) is distributed among those who are insiders to the firm as per contracts with various participants in the value creating process. The proponents of the stakeholder theory of corporate governance argue that managers should consider interests of all stakeholders (including shareholders) in deciding the mobilization and allocation of resources to different uses. In other words, managers should balance the interests of all stakeholders, which are often conflicting. The most important weakness of the stakeholder theory is that it fails to provide a single objective function to managers, and thus dilutes accountability. Moreover, it undermines the fact that investors will be motivated to invest in a firm only if, they are assured that the funds provided by them will be used to create value for them. In spite of these weaknesses, the stakeholder theory highlights the fact that the 'firm value' cannot be maximized ignoring the interests of all stakeholders for long. Therefore, managers should

take all stakeholders together in achieving the core objective function, that is, 'maximisation of the firm value'.

In this paper we shall focus on the shareholder theory of corporate governance. We shall not deal with issues such as 'corporate social responsibilities', corporate citizenship (e.g. responsibility of companies to behave like good citizens) and ethics.

There is a large literature in economics on the nature of firm. Understanding corporate governance requires understanding the nature of the firm, particularly, limited liability companies. Therefore, sections 2 and 3 provide an overview of the nature of a firm and the structure of limited liability companies. Sections 4 and 5 of the paper discuss the concept of corporate governance and corporate governance issues in international joint ventures respectively. Section 6 discusses the role of State in corporate governance.

2. NATURE OF FIRM

A firm as a nexus of contracts

Alchian and Demsetz (1972) define a firm as a nexus of contracts. A firm may be viewed as a nexus of contracts between stakeholders, including the local community. Some contracts are explicit (e.g. contracts between the manager and financiers, customers, suppliers and employees) and some others are implicit (e.g. contract between the managers and the local community under which the former undertakes not to create negative externalities⁴). According to this definition corporate governance is governance of a complex network of contracts. The key issue in governance of a contract is how the contracting parties share the 'quasi rent'⁵ arising from contingencies. In absence of a complete contract, which covers all contingencies, the distribution of the quasi rent depends upon the ex-post⁶ relative bargaining powers of contracting parties. The ex-post relative bargaining powers of contracting parties depend on ex-ante contract between the parties, the institutions in the business environment where the contracting parties operate and alternatives available to contracting parties. We may take an example. B & Co. is looking for a supplier for a special machine to be manufactured specially for it. Until the search for the right supplier is complete, that is, up to the bidding stage, B & Co. operates in the market. Once the search is complete, B & Co. enters into a contract with the supplier (say, S & Co.) specifying the terms and conditions, including the specification of the machine, delivery schedule, the price and payment terms. The manufacturing of the machine takes a significantly long period. Suppose due to change in the business environment (e.g. increase in demand for capital goods) the contract with B & Co. becomes un-profitable (considering the opportunity cost⁷). The probability that S & Co. will execute the order depends on the ex-post relative bargaining powers of B & Co. and S & Co. The relative bargaining powers depend on the ex-ante contract (e.g. penalty clause in the contract), institutions (e.g. the possibility of court's intervention in getting the contract executed, the speed with which the news spreads in the market and adversely affects the future business of S & Co.) and the alternatives available to B & Co. for getting the machine manufactured. As in this example, the distribution of the value created in a firm is determined by relative ex-post bargaining powers of parties

participating in the production process. In case of a firm, situations for renegotiation arise continuously. This enhances the importance of relative ex-post bargaining powers of contracting of parties. The power (residual control right⁸) of managing the assets is the prime determinant of the ex-post bargaining powers of different contracting parties.

In the context of transaction costs in trading between two entities Williams (1991) observes:

‘The initial franchise award undergoes a Fundamental Transformation if the assets in question are highly specific, in which event the efficacy of “unassisted” franchise bidding becomes highly problematic at the contract renewal intervals and when adaptations to change are attempted’.

Fundamental transformation occurs when production of the goods by the supplier requires large durable investments, which are specific to the needs of the buyer and are not redeployable. The specificity of the investment or ‘lock-in’ weakens the ex-post bargaining power of the supplier vis-à-vis that of the buyer. In absence of a complete contract, which takes care of all possible contingencies, the seller builds flexibility in its production process to strengthen its ex-post bargaining position. This increases transaction costs and brings down the economic efficiency. This is one of the reasons why firms go for ‘vertical integration’.

Robert (2004a) observes:

‘Lock-in is actually inevitable when assets are specialized. An asset is specialized to a particular use when the value it can create in its next-best alternative use is substantially lower than what it yields in the current one. For example, the dies used to shape materials in manufacturing are very specific to that use: If they are not employed for this purpose, they are just scrap material. Firm-specific human capital—the knowledge that is only (or especially) valuable in the context of employment with a particular firm—is another example. When assets are specialized, they are subject to hold-up—attempts by trading partners to appropriate some of the returns that the assets’ owners expected when they invested in them. This can lead to a variety of inefficiencies.’

The lock-in, similar to that discussed in the context of trading, arises when an investor invests in equity of a firm because assets that a firm uses are specialized and do not have alternative uses. Therefore, there is a need for a governance system that ensures that managers do not expropriate wealth of investors and that investors get expected return on their investment and gets back the principal amount invested in the firm.

Although, the current discourse on corporate governance focus on financiers’ interest only, employees’ interest should receive due attention by policy makers. The ex-post bargaining power of employees in many industries, particularly in firms that are operating in a matured industry is weaker than suppliers of other inputs. This is so because in absence of new investments in the industry employees face a ‘take it or leave

it' situation. On the other hand in a growing industry, which is technology or relationships driven, employees enjoy a significant ex-post bargaining power, because they can threaten to withdraw valuable resources (e.g. knowledge and skills) that they bring to the firm. The position of employees is different from suppliers of other inputs for two reasons. First, the term of contracts with employees is usually longer as compared to term of contracts with suppliers of other inputs. This makes the nature of stake of employees different from the nature of stake of suppliers of other inputs to the firm. Although, it may not be true in all situations, usually a firm has an option to purchase inputs in a spot-transaction. In most situations this option is not available for employee services. Second, and more importantly, the specificity of investment of knowledge and skills, which stays with employees, makes employee services different from other inputs. Roberts (2004b) observes:

‘... when a customer “ fires” a butcher, the butcher keeps the inventory, tools, shop, and other customers she had previously. When an employee leaves a firm, in contrast, she is typically denied access to the firm’s resources. The employee cannot conduct business using the firm’s name; she cannot use its machines or patents; and she probably has limited access to the people and networks in the firm, certainly for commercial purposes and perhaps even socially.’

Above observations are more appropriate for employees working in industries in which inanimate assets are significantly more important than capabilities (e.g. abilities to build relationships with buyers and sellers in a banking industry, knowledge and skills to develop complex client-specific software) that individuals carry with them.

Firm as a collection of assets

Grossman and Hart (1986), and Hart and Moore (1990) define a firm as a collection of assets that are jointly owned. For example, in a typical firm, equity holders and debt holders jointly own assets. The ownership is important because it provides rights to control the assets. Equity holders provide the risk capital and undertake business risks, while an investment in the debt capital is exposed to credit risks⁹. The claim of equity holders on the assets is residual in the sense that in a situation of liquidation of the firm, equity holders have claim on assets that are available after payment of the claims of debt holders and other creditors. Therefore, the law gives the ownership rights to equity holders. Conflict of interest between equity holders and debt holders arises in a situation of distress, when the asset of the firm is inadequate to pay creditors, including debt holders. In that situation equity holders tempt to invest in a speculative project. If the actual outcome of the project results in high pay-off, it benefits equity holders, but if it results in huge loss it hurts debt holders. In this context the ownership right is important. The ‘ownership rights’ approach suggests that corporate governance system aims to ensure that equity holders take decisions for the benefit of all classes of investors including debt holders.

Firm as a nexus of specific investments

Rajan and Zingales (1998) define a firm as a nexus of specific investments: a combination of mutually specialized assets and people. The definition emphasizes the specificity of resources (assets and people) invested in a firm. It also emphasizes that the firm is a complex structure that cannot be replicated by the market immediately. According to this definition, corporate governance is concerned with distribution of quasi rent accruing to the firm among mutually specialized parties who have sunk financial and/or human capital in the firm.

Raghuram and Zingales (2000) observe that an individual can derive power from the valuable resources she brings to the production process. In an industry that requires significant investment in tangible assets (e.g. equipment) the power to control stays with the top management, because it brings the knowledge and managerial skills that is required to make the assets productive. It derives the power because it can threaten to withdraw the scarce resources that it brings with it, which will make the investment in tangible assets non-performing because of the specificity of investment. In a large corporation, investors are like absentee landlords. They cannot exercise their ownership rights because the power to control assets rests with the top management whom investors hire to manage the business.

In a technology driven company (e.g. bank and software companies), specialised human capital has become equally, if not more, important as inanimate assets. It is not only the top management, but even employees occupying lower positions bring specialised knowledge and skills with them. Therefore, in those companies power to control is distributed among employees at all levels. From this perspective, corporate governance should address the problem of self-dealing by top management and other employees.

All the three definitions of a firm are complementary, although they view a firm from different perspectives. Understanding all the three perspectives is important to understand different facets of corporate governance.

3. THE MANAGEMENT STRUCTURE OF LIMITED LIABILITY COMPANIES

Limited liability company structure is the most commonly used organization structure to conduct a large business. When a business grows, the entrepreneur needs funds. She promotes a limited liability company to collect equity capital and debt capital from financial intermediaries (e.g. banks and developmental financial institutions), friends, family members and public. A company that does not collect funds from the public is known as private limited company (often called closely held company). A company that collects funds from public is known as public limited company. An Investor in the equity of a limited liability company has no liability beyond the amount she agrees to contribute to the capital of the company. In other words, if the value of the assets of a company falls below the aggregate amount of claims of creditors (including debt holders), equity holders are not required to introduce fresh capital in the company to pay creditors. This helps a company to invest in risky projects. A limited liability company is a legal fiction; it has a juridical personality. It can sue and be sued in its own name; it can purchase, sale, and hold assets in its own name; it has perpetual succession in the sense that it continues

to exist even if its promoters and other members (investors in the equity capital of the company), who contributed the initial capital, cease to exist because of death or transfer of shares. A limited liability company continues to exist until it is legally wound up voluntarily or otherwise. Shares in a limited liability company are transferable.

A limited liability company (company in rest of the article) comes into existence by completing formalities required under the law and by submitting, among other documents, a 'memorandum of association' with the appropriate authority. The memorandum of association is a public document that states, among other things, the objectives that the company will pursue. Moreover, a company issues a 'prospectus' while inviting investors to contribute to the capital of the company. The prospectus, among other things, states the purpose for which funds will be used. Thus, there is an implicit contract between investors and the promoter (the entrepreneur who promotes the company) on how the funds will be used and how returns will be divided between the entrepreneur and investors. In addition, a company, at the time of registration files with the appropriate authority a document that sets out the rules for internal management of the company. The document is called 'articles of association'. The Companies Act governs the formation and management of a company and defines the rights and duties of investors in the capital of the company. It also prescribes penalties for different types of violation of the law. The 'memorandum of association', the 'articles of association', the prospectus and provisions of the company law may be deemed to be components of a comprehensive contract between the company and investors.

When an entrepreneur borrows money from a financial institution, she signs a contract with the financial institution explicitly.

The ex-ante contract that is entered into between the management and investors, particularly with equity investors, is too broad and does not cover all contingencies because those cannot be foreseen. Therefore, those contracts are subject to interpretations. As a result, courts do not intervene in enforcing those contracts on the ground of 'business judgment' unless there is massive violation of investors' rights. One solution to the problem is the investors retain the rights to take decisions in contingencies. The solution is not feasible because of two reasons. The first and the most important reason is that investors are not qualified and informed enough to take decisions. The second reason is that investors of publicly traded companies¹⁰ are large in number and are dispersed, and therefore, it is impractical, if not impossible, for them to take decisions collectively in every contingent situation that occurs after the investment is made. The free rider problem¹¹ dissuades small investors to acquire knowledge and information about the business of the company and to actively participate in decision making.

An equity shareholder enjoys many rights, the most important of which is the voting right. Usually, each share has one voting right. An investor can exercise the voting right to elect her nominee to the board of directors. The board of directors acts as a trustee for equity shareholders. The board has a fiduciary¹² relationship with investors. In practice, small investors seldom exercise the right in the general meeting. As a result an investor or

a group of investors who hold the majority voting shares or who can organize proxies¹³ get its nominees elected to the board. Therefore, although theoretically, an individual or group holding more than 51 per cent of the voting rights in a company can get its nominees elected to the board, in practice, in most situations, an individual or a group holding less than 51 per cent of the voting rights (but more than any other individual or group) controls the board of directors of the company. Some decisions can be taken in the general meeting only by a special resolution¹⁴. Therefore, an investor who holds 26 per cent of the voting rights can block a decision that the law requires to be taken by shareholders by a special resolution.

In practice, the incumbent management gets its nominees elected to the board of directors, unless there is war to take over the control of the company between rival groups. In general, the exercise of the voting right in a general meeting is costly for small and dispersed shareholders. Therefore, they prefer to sell shares of an under performing company rather than changing its board of directors.

The role of the board of directors

The board of directors, elected by shareholders, has the responsibility to oversee the executive management to ensure that it does not expropriate or waste the wealth of investors. Board of directors has the responsibility to appoint right individuals for top positions, to formulate right incentive contracts to ensure economic efficiency and to renegotiate contracts with the top management in situations not covered in the extant contract. More specifically, the responsibilities of the board include:

- a) To appoint the Chief Executive Officer (CEO) and other senior executives of the company
- b) To terminate the services of the Chief Executive Officer, if required
- c) To ensure that the internal control system is adequate and operating effectively
- d) To review the vision and mission of the company
- e) To review the strategy of the company
- f) To review financing and operating decisions of the company
- g) To decide compensation (including incentives) of the Chief Executive Officer and other senior executives of the company
- h) To review the performance of the board

The board is in a fiduciary relationship with investors and should take care of their welfare, particularly the welfare of equity holders. In a way the board is accountable to shareholders and the executive management is accountable to the board of directors.

The effectiveness of the board of directors depends on the independence and capabilities of the board members, the motivation of the board members to effectively contribute to the board process and the effectiveness of the board process.

4. THE CONCEPT OF CORPORATE GOVERNANCE

In a limited liability company ownership rights vest with equity shareholders. However, they can seldom exercise those powers because they do not have the technical and managerial skills required to manage the business and also because they are small and disposed. They invest in the equity of a company because they are ready to take higher risk (than risk in investment in treasury bills or corporate bonds) in expectation of higher return. Their choice of a security is not based on their love for particular businesses. An investor selects a security based on the economics of investments. The power to control rests with top management or it is distributed among employees of a company based on the nature of the industry in which the company operates. The residual control rights that the top management enjoys are much more extensive than what it would have been had the courts and shareholders were much more active in enforcing ex-ante contracts between shareholders and managers. In the context of publicly traded companies equity investors are principals and the manager is the agent. The capital market theory establishes that in an economy with a well functioning capital market, managers serve the welfare of investors by 'maximising the firm value'. They need not have to bother about the economic needs of each individual investor. Therefore, a manager should take decisions that will enhance the value of the firm. Although the top management (manager in rest of the article) is expected to act as the agent of equity shareholders and take decisions for their welfare, it might use their power to control for self-dealing.

The promoter manager or the professional manager controls 100 per cent of the assets of the company with less than 100 per cent cash flow right, which is proportional to the shareholding of the manager in the equity capital of the company. Most individuals are selfish and they tend to maximise their own benefits and to pass on the costs that they should bear to others. Managers are no different. A manager tempts to expropriate investors' funds, because she gets 100 per cent of the fund expropriated, while she gets only a part of the increase in value of the company, if her shareholding is less than 100 per cent. Expropriation may take many forms, such as:

- a) Absconding with the money;
- b) Selling the output of the firm to other manager owned businesses at below market prices (transfer pricing);
- c) Selling the assets of the firm to other manager owned businesses at below market prices;
- d) Diverting funds to themselves (managerial compensation and perquisites); and
- e) Expanding the firm beyond what is rational, reinvesting the free cash, pursuing pet projects, and projects that benefit them rather than investors.

Grossman and Hart (1988) describe these benefits as the 'private benefits of control'.

The problem arising from the principal-agent relationship between the manager and equity holders give rise to the agency problem.

Agency problem

Jensen and Meckling (1976) observe:

‘We define agency relationship as a contract under which one or more persons (principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers, there is a good reason to believe that the agent will not always act in the best interest of the principal. The principal can limit divergence from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. In addition, in some situations it will pay the agent to expend resources (bonding costs) to guarantee that he will not take certain actions that will harm the principal or to ensure that the principal will be compensated if he does take such actions. However, it is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal’s viewpoint. In most agency relationships the principal and the agent will incur positive monitoring and bonding costs (non-pecuniary as well as pecuniary), and in addition there will be some divergence between the agent’s decisions and those decisions that would maximize the welfare of the principal. The dollar equivalent of the reduction in the welfare experienced by the principal as a result of this divergence is also a cost of the agency relationship, and we refer to this latter cost as “residual loss”. We define agency costs as the sum of:

1. The monitoring expenditures by the principal.
2. The bonding expenditures by the agent.
3. The residual loss.’

Shleifer and Vishny (1997) describe the agency problem as follows:

‘The agency problem is an essential element of the so-called contractual view of the firm. The essence of the agency problem is the separation of management and finance, or – in more standard terminology– of ownership and control. The agency problem in the context of a publicly traded company refers to the difficulties financiers have in assuring that their funds are not expropriated or wasted on unattractive projects’.

Corporate governance

In a limited liability company, usually, the manager enjoys the power to control and consequently enjoy greater ex-post bargaining power than equity shareholders, who enjoy the ownership rights. Zingales (1998) defines corporate governance as the complex set of constraints that set the ex-post bargaining over the quasi-rent generated by a firm.

Shleifer and Vishny (1997) describe the corporate governance as follows:

‘Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. How do

the suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects? How do suppliers of finance control managers’?

In general, corporate governance refers to mechanisms that aim to reduce ‘agency costs’ primarily by providing right incentive to the manager and by monitoring and controlling his decision.

Incentive contracts

One solution to the agency problem could be to grant a manager highly contingent, long term incentive contract ex-ante to align her interest with those of investors. Incentive contracts are common in practice. Managers are offered variable pay based on the performance of the company. Many companies offer share based payments (e.g. Employees Stock Options) to align their interest with those of investors. However, there are serious problems with high-powered incentive contracts. Incentive contracts should reward or punish managers based on objective measure of performance. The optimal contract should take into account, among other things, the risk aversion of the manager and the effect of her decision on the firm. Theoretically, a manager’s risk appetite is expected to be lower than equity shareholders. It is difficult to formulate the optimal contracts for different managers and for different contingencies. Moreover, incentive contracts create enormous opportunities for self-dealings to the manager. For example, incentives linked to performance may drive managers to manipulate data, for example, managers may resort to earnings management. Another problem with incentive contracts is that those are to be renegotiated continuously to suit the changed business environment. The manager, who is in a strong bargaining position, may negotiate incentive contracts when they know that earnings or share prices are likely to rise. The opportunities for self-dealing increases manifold when managers negotiate incentive contracts with poorly motivated boards of directors. Literature has found a small sensitivity of executive compensation to the share price.

Passive monitoring

Corporate governance models focus on monitoring and control of the manager. Monitoring and control may be passive or active. Passive monitoring and control (information signals) usually come from the capital market. For example, an institutional investor or pension fund disinvests (“exits”) if performance of the firm is poor. Therefore, transparency in and timeliness of corporate financial reporting enhances passive monitoring and control. However, many economists believe that short-termist and bias decisions of institutional investors reduce the effectiveness of passive monitoring and control very significantly. At the worse, it might adversely affect the quality of corporate governance, because it may tempt managers to ‘maximize the firm value’ in the short-term rather than pursuing strategies that would maximize the long –term value of the firm.

Active monitoring

The board of directors, a large shareholder, institutional investors and large creditors are involved in active monitoring and control. Institutional investors often behave like small-dispersed investors and do not spend resources for active monitoring and control of the firm, because of the 'free-ride' problem. They prefer to exit an under performing company rather than spending resources to improve its performance.

Evidence suggests that concentration of ownership improves the control of managers by overcoming the 'free-ride' problem. However, evidence suggests that a financial institution having large investment intervenes only when the firm is in distress. On the negative side, a large shareholder may indulge in 'self-dealing' and create private benefits. This adversely affects the interest of small shareholders or debt holders.

Evidence points at board of directors dominated by the incumbent management. Therefore, most corporate governance codes prescribe for "balanced board" with adequate number of "independent directors", and separation of the positions of the chairman and the chief executive officer. For example, in India, clause 49¹⁵ of the listing agreement requires that not less than 50% of directors should be non-executive directors; there should be at least 50% independent directors¹⁶ if the chairman is an executive chairman; and in case of non-executive chairman at least one-third should be independent directors. The expectation is that a balanced board would be able to carry on its responsibilities objectively. However, evidence suggests that even a balanced Board of directors react very late and mostly under outside pressure.

Holmstrom and Kaplan (2003) observe:

"Despite the improvements noted above, the recent events like Enron, Tyco, and WorldCom suggest that the boards of U.S. companies continue to exhibit less than the optimal amount of independence and oversight. The Sewate report on Enron's board is particularly critical in this respect. When a company is not doing well, everyone pays close attention – lenders and investors as well as board members. But when a company appears to be doing well, as was the case with both Enron and Tyco, investors and the board is likely to be less critical."

Debt is another instrument to discipline managers and reduce agency costs. The failure to repay the debt results in transfer of control from the manager to the creditor. Therefore, the manager works hard to avoid default. On the negative side, the debt holder, because of its relatively high bargaining power, may extract rent from the firm. Moreover, excessive debt in the capital structure may cause debt overhang, where the manager does not choose a good project because most returns will go to debt holders.

Presence of a corporate control market helps to improve corporate governance. Proxy contests, friendly mergers, and hostile takeovers are considered complementary with internal control mechanisms. The threat of take over motivates the incumbent

management to perform at the optimal level. However, there is scant evidence that operating performance of a firm increases with a takeover.

Board effectiveness

The size of the board of directors is an important variable that determines the effectiveness of the board. With regards to the board size, most experts believe that optimal size should be between 6 to 8 members.

Most corporate governance codes (including clause 49 of the listing agreement) suggest measures for effective functioning of the board of directors. For example, one of the requirements of the corporate governance code is that the board should function through committees, which are constituted of independent directors. Most companies constitute committees (e.g. audit committee, investors' grievance committee, remuneration committee, nomination committee) that handle sensitive issues and facilitate decision-making by the board of directors. Usually corporate governance codes stipulate constitution of committees and scope of work of each committee.

Corporate Governance codes also specify the board process to ensure that the board agenda includes important issues that come under the purview of the board. The most important issue that is yet to be resolved is how to motivate independent directors to spend adequate time to understand the business and to contribute effectively to the board process. Usually corporate governance codes limit the number of boards in which an individual can join as a director so that an individual can do justice to his board positions. However, this is not adequate to motivate an individual to contribute effectively to the board performance. Some argue that a board member should be compensated adequately for the time she spends to re-serve the board effectively. They believe that the present sitting fee is inadequate. It is difficult to determine what the optimal compensation to a director is because a high compensation might adversely affect the independence of a director. Some others argue that an individual should invest a significant part of her wealth in the equity of the company in which she joins as a board member. They argue that an individual having a stake in the company is expected to have motivation in improving the performance of the company. However, this is not a feasible solution. An individual holds a well-diversified portfolio and does not want to expose her investment to undue risks by investing in a single security. Moreover, none prefers to invest in an underperforming company and consequently such a company will find it difficult to get right individuals in its board of directors. Under the company law, even an independent director is liable for violation of law and other wrongful acts of the company. Although, many argue that the threat of penalty motivates a director to use 'due diligence'. But, in practice, penal provisions dissuade individuals from joining board of companies that do not have a track record of good corporate governance. Moreover, usually courts do not intervene and impose penalties for negligence on the ground of 'business judgment' unless there is gross violation of investors' rights.

Poorly motivated directors bring down the effectiveness of the board.

5. CORPORATE GOVERNANCE IN INTERNATIONAL JOINT VENTURES

Foreign direct investment (FDI) occurs when a firm undertakes an investment in an overseas enterprise, in which the foreign investor has both the lasting interest and substantial control. FDI implies that the investor exerts a considerable degree of influence on the management of the overseas enterprise. FDI can be wholly owned (either acquisitions or green field) or joint ventures. With FDI, the investing firm assumes greater risks, compared with licensing or exporting, but has considerably more management control over the overseas operation.

For the host country it is a source of additional external finance (and of risk capital) augmenting fixed investment, potential output and employment. FDI is also seen as a source of technology and management skill, creating tangible and intangible assets in the host country. However, empirical researches throw mixed results. Many researchers find that in practice FDI does not create the benefits that are expected to flow to the host country. For example, see Petras (2005)

Corporate governance in the context of FDI is examined from the point of view of the relationship between the foreign investor and the partner from the host country (local partner) in a joint venture.

Corporate governance in an international joint venture (IJV) needs to focus on certain complex issues, which can be summarized as follows:

- d) Control by the foreign partner without majority voting power because the State puts restrictions on the share holding of the foreign partner or on the voting power of the foreign partner.
- e) Separation of strategic control and operating control.
- f) Focus on maximization of value for the shareholders of the foreign partner rather than maximization of the value of the IJV.

Bargaining power approach

The relative bargaining power of the foreign partner is the most important variable that determines the relationship between the foreign partner and the partner from the host country (local partner). Usually joint venture partners compete and cooperate at the same time. Negotiations between partners commence from the conceptualization of the IJV and continue through out the life of the IJV. Therefore, most researchers analyse the structure and productivity of joint ventures from the 'bargaining power' approach.

A foreign partner enters the host country (e.g. India) through a joint venture with as much equity holding as is permitted by the local government. Child and yan (1999) observes that there is a strong relationship between the equity shareholding of the foreign partner and its strategic control over the IJV. The motivation of the joint venture partner to

participate in strategic decision-making comes from the fact that the objectives that the local partner wants to achieve might differ from those of the joint venture partner. Governments in developing countries usually put restrictions on the shareholding of a foreign partner in an IJV. A Government determines different limits for FDI for different industries depending on the expected role of different industries in socio-economic development of the country and similar other factors such as security of the country. For example, the Indian government has established 26 percent equity cap for the insurance sector. The low equity cap for the insurance sector reflects the governments concern that if a foreign partner is allowed to have strategic control over an insurance IJV, the firm may undermine its role in socio-economic development of the rural population. A cap on the foreign equity holdings makes a proposal to establish an IJV unattractive to a prospective foreign partner because it restricts the strategic control and reduces the chances that the foreign partner would achieve its objectives.

A foreign partner provides important intangible assets like technology, managerial skills and brand. It is difficult for the foreign partner to write a complete (long term) contract regarding the use of those assets and thus to protect them from misuse. Therefore, it has a motivation to participate in operating decisions significantly.

Although the ownership right of the joint venture partner flows from its equity holding in the joint venture, its ability to control the operations of an IJV depends on its bargaining power. The relative bargaining power of the foreign partner is determined by the relative importance of intangible asset brought by the foreign partner vis-à-vis the intangible assets (e.g. information about the local market, managerial and marketing skills relevant in the host country) provided by the local partner. If the intangible asset provided by the foreign partner is proprietary and the foreign partner's continued commitment to provide access to those intangibles is essential for the success of the joint venture, the foreign partner has a very strong bargaining power. In that situation the percentage of shareholding in the equity of the joint venture is irrelevant in determining the power of the foreign partner to control the operating decisions and some times the strategic decisions of the joint venture. However, the relative bargaining powers of the foreign partner and the local partner changes over time due to changes in the business environment (see Nakamura, 2005). The shift in the bargaining power is primarily determined by the extent of learning by both the partners from each other. For example, when the foreign partners acquires the knowledge (e.g. market dynamics, work culture, and the legal environment in the host country), which was originally brought by the local partner, the foreign partner might prefer to go alone and set up a 100 percent subsidiary in the host country. Similarly, when the local partner acquires the knowledge (e.g. proprietary technology and net working) that was originally brought by the foreign partner, the local partner might not need the support from the foreign partner. Therefore, researchers observe that international joint ventures are typically unstable over time.

6. THE ROLE OF STATE IN CORPORATE GOVERNANCE

The state plays a very important role in corporate governance because it provides the legal environment in which a firm operates.

While discussing the legal basis for a firm, Scott (1991) observes:

‘Ex-ante, contracting is a flexible institution. Trans actors can, at least in principle, design each relationship to suit their particular needs. In all but the simplest exchanges, however, the process of exploring and stipulating details of a transaction can become expensive very quickly. In addition, many basic terms and conditions are likely to be common across transactions. To minimize the costly duplication of identical provisions in individual contracts, the law provides a set of standard doctrines and remedies to deal with recurring contractual events. Thus, both court-determined penalties for contract breach and common law application of force majeure criteria can be interpreted as substitutes for the redundant stipulation of common provisions by individual Transactors. At the same time, courts recognize the diversity of transactions and give parties wide latitude to augment or modify the terms of the agreement by mutual consent. The existence of a standard set of doctrine to govern contractual exchange and the ability to “contract out of or away from” the governance structures of the state by devising private orderings” (Williamson, 1983:520) combine to provide a degree of both economy and flexibility in constructing contractual relationships.’

The State also creates various institutions that influences the relative bargaining powers of contracting parties in a firm, the law provides standards terms of ex-ante contracts and thus establishes ex-ante bargaining powers of contracting parties. For example, labour laws determine the ex-ante bargaining power of employees. Similarly, the company law and regulations governing publicly traded companies is significantly influences the ex-ante bargaining power of equity investors and directors. The ex-post bargaining power of contracting parties is influenced by the approach of the institutions that have the responsibility to enforce the law. For example, the ex-post bargaining power of employees is influence by the approach of the conciliation authority that arbitrates in a dispute between an employee and its employees and also on the approach of the judiciary which hears the dispute between an employer and its employees. If the conciliation authority considers its responsibility to protect interests of employees, the outcome of arbitration would be different from the outcome of an arbitration in which the conciliation authority takes the position of a facilitator in the negotiation between an employer and its employees. Similarly, the ex-post bargaining power of investors and directors is influenced by the approaching of the judiciary in determining the extent to which it should intervene in the internal management of the firm.

Corporate governance from the perspective of the relationship between the foreign investor, the partner from the host country, and the government of thee host country should be viewed as the governance of contracts. FDI results in a tripartite contract among the State, the foreign partner and the partner from the host country. The

government policy and regulation are the instruments that set the contractual terms and conditions from the perspective of the State. The governance issue arises when the terms settled ex-ante is not adequate to take care of contingencies occurring after the initial contract and the question of sharing the quasi rent arises. The sharing depends on the relative bargaining power of the contracting agents. The government changes policy and regulations in favour of foreign investors if they as a group enjoy strong bargaining power. This reduces the pay off to the host country from the FDI. Therefore, the governance from the point of view of the State requires managing the bargaining power of the foreign investor. The State endeavors to do the same by restricting FDI only in those areas where the potential for technical and other spill over is high and by creating indigenous capabilities to avoid total dependence on foreign investment in a particular area.

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¹ Economic efficiency is achieved when the value assigned to waste or "friction" or other undesirable economic features in the production process is reduced to the minimum.

² Economies of scale and [diseconomies of scale](#) refer to an economic property of production that affects cost if quantity of all input factors by some amount is increased. If costs increase proportionately, there are no economies of scale; if costs increase by a greater amount, there are diseconomies of scale; if costs increase by a lesser amount, there are positive economies of scale. When combined, economies of scale and diseconomies of scale lead to [ideal firm size](#) theory, which states that per-unit costs decrease until they reach a certain minimum, then increase as the firm size increases further. The ideal firm size is the theoretically most competitive size for any company, in a given industry, at a given time; which should ideally correspond with the highest possible per-unit profit.

³ Economies of scope are conceptually similar to [Economies of scale](#). Whereas economies of scale apply to efficiencies associated with increasing or decreasing the scale of production, economies of scope refer to efficiencies associated with increasing or decreasing the scope of business through diversification, [marketing](#) and [distribution](#). Whereas economies of scale refer to changes in the output of a single product type, economies of scope refer to changes in the number of different types of [products](#). Whereas economies of scale refer primarily to supply-side changes (such as level of production), economies of scope refer to demand-side changes (such as marketing and distribution). Economies of scope are one of the main reasons for diversification and such marketing strategies as [product bundling](#), [product lining](#), and [family branding](#). 'Economies of scope' is achieved when a firm leverages resources across business units from a cost perspective.

⁴ In [economics](#), an externality occurs when a decision (for example, to pollute the atmosphere) causes costs or benefits to [stakeholders](#) (e.g. local community) other than the person making the decision. In other

words, the decision-maker does not bear all of the costs or reap all of the gains from his action. Negative externality is used to refer to external cost or external diseconomy. For example, a firm may create negative externality by producing a product, the use of which pollutes the environment, which in turn creates health hazards for those who do not benefit from the production or consumption of that product.

⁵ In economics ‘economic rent’ refers to the payment to a factor of production (e.g. land) in excess of that which is needed to keep it employed in its current use. Quasi rent refers to the rent that accrues to the superior proprietary assets of a firm which is in the nature of economic rent, similar to the economic rent that accrues to a superior piece of land.

⁶ *Ex ante* is a [Latin](#) term meaning "beforehand". The opposite of *ex ante* is *ex post*, meaning "after the fact". *Ex ante* contract refers to the contract when the fund is invested in the company and sunk in the business.

⁷ Opportunity cost is a term used in [economics](#), to mean *the cost of something in terms of an opportunity forgone* (and the benefits that could be received from that opportunity), or *the most valuable forgone alternative*.

⁸ Residual control right’ refers to the discretionary rights to decide the use of assets in contingencies (situations that are not covered by the contract between parties that jointly own the assets). In business, contingent situations arise frequently because a contract cannot cover all contingencies that might arise in a business. In a sense all contracts are incomplete contracts. Residual control right is valuable because it can be used strategically to enhance the bargaining power in negotiating surplus (quasi-rent) arising due to occurrences of contingencies not included in the contract.

⁹ Credit risk refers to the risk that the investor may not get the promised return on her investment and/or may not get back part or full amount invested in the debt capital of the firm.

¹⁰ A publicly traded company is a company equity capital of which is provided by shareholders who are members of the general public and who trade [shares](#) publicly, often through a listing on a [stock exchange](#). Ownership of equity shares is open to anyone who has the [money](#) and inclination to buy shares in the company. It is differentiated from [closely held companies](#) (often called private limited companies) where the shares are held by a small group of individuals often members of one or a small group of families or

otherwise related individuals (or other companies). Any entity (e.g. partnership firm and institutional investors), including individuals can hold equity shares in a limited liability company.

¹¹ In [economics](#) and [political science](#), free riders are actors who consume more than their fair share of a resource, or shoulder less than a fair share of the costs of its production. The free rider problem is the question of how to prevent free riding from taking place, or at least limit its negative effects.

¹² In many [common law](#) jurisdictions, fiduciary is a legal term used to describe a relationship between a person who occupies a particular position of trust, power or responsibility with respect to the rights, property or interests of another. Common relationships with this character are those of a guardian and a ward, an attorney and a client, and a trustee and a beneficiary. In general, a fiduciary must act for the benefit of the person to whom she owes fiduciary duties, to the exclusion of any contrary interest. The fiduciary duty is often termed as the ‘duty of loyalty’.

¹³ The corporate law in almost all jurisdictions allows an equity share holder, who does not attend a general meeting in person, to vote through proxy by authorizing some one to vote on her behalf.

¹⁴ A resolution in a meeting of the shareholders is a special resolution when the votes cast in favor by shareholders are not less than three-fourth of the total votes cast, either in person or through proxy.

¹⁵ Clause 49 of the Listing Agreement between a stock exchange and the company which want to list its securities in the said stock exchange incorporates the corporate governance code issued by the Securities and Exchange Board of India (SEBI), which regulates capital markets in India.

¹⁶ An independent director is one who apart from receiving director’s remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries or associates which may affect the independence of the director. Clause 49 of the Listing Agreement specifies disqualifications for an independent director.